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National Industrial Conference
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Brief analysis of War revenue
bill H.R. 12863 as affecting
industry

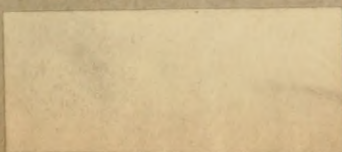
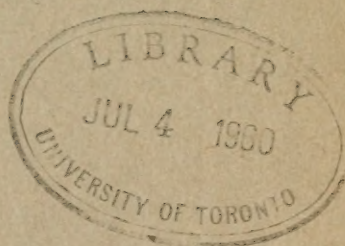
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Revenue Bill H.R. 12863
as Affecting Industry

National Industrial Conference Board

January 27, 1919

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National Industrial Conference Board

15 BEACON STREET, BOSTON, MASS.

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THE National Industrial Conference Board is a co-operative body composed of representatives of national industrial associations, and organized to provide a clearing house of information, a forum for constructive discussion, and machinery for co-operative action on matters that vitally affect the industrial development of the nation.

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Brief Analysis of War Revenue Bill

H. R. 12863 as Affecting Industry

PRESENT STATUS

The Revenue Bill now in conference between the House of Representatives and the Senate will probably not be reported and passed before February 15th. The Treasury Department has, however, announced that income and profits taxes upon income of 1918 are not to be collected under existing law but under the new Act. Certain new taxes will go into effect upon the passage of this Act. It therefore seems advisable to furnish a brief statement of the substance of the bill as it passed the Senate and was sent to conference, even though the conferees may make substantial changes.

ESTIMATED YIELD

The estimate set forth in the report on the bill to the Senate by the majority of the Senate Finance Committee was as follows:

Income tax	\$2,207,000,000
War excess profits tax	2,400,000,000
Estate or inheritance tax	100,000,000
Tax on transportation and other facilities	229,000,000
Tax on beverages	450,000,000
Tax on cigars and tobacco	240,600,000
Admissions and dues	54,000,000
Excise taxes	123,000,000
Special taxes	73,866,000
Stamp taxes	31,000,000
Floor taxes	70,000,000
Total	\$5,978,466,000

Upon the floor of the Senate certain new "semi-luxury" taxes devised by the House but struck out by the Senate Finance Committee were restored in modified form. The

bill also carried lower rates of individual and corporate income taxation for 1919 payable in 1920. The essence of the measure in its revenue aspects was set forth by the committee as follows:

“For the fiscal year 1919 it is planned to raise nearly \$4,600,000,000 from income and profits taxes, and something like \$1,400,000,000 from other sources; for the fiscal year 1920 it is planned to raise somewhat less than \$3,000,000,000 from income and profits taxes, and about \$1,000,000,000 from other sources.”

The amounts so to be raised by taxation for the fiscal year 1919 are against an estimated total expenditure by the Government of \$18,000,000,000, the balance of the expenditures being raised by borrowing. The amounts to be raised by this bill are without question the largest amounts which any country has attempted to secure by taxation.

ALL THE LAW IN A SINGLE STATUTE

A great advantage of the legislation of this year over last year's legislation is that all the current internal revenue law has been put into a single statute. Taxpayers are saved a great inconvenience which they suffer under last year's legislation of having to consult more than one Act.

INDIVIDUAL INCOME TAX

Credits Allowed: The new Act provides for a credit against income otherwise taxable of a personal exemption of \$1,000, or in the case of the head of a family or married person, of \$2,000, with an additional amount of \$200 for certain dependents upon the taxpayer.

Rates: The normal tax upon the taxable net income of an individual in excess of the credits allowed is, for 1918, 6% on the first \$4,000 and 12% on all over that amount; and for 1919 and thereafter, 4% upon the first \$4,000 and 8% on all over that amount. With reference to the surtax rates, the report made the following statement:

“The surtax rates approved by the committee begin with 1% upon incomes in excess of \$5,000 and not in excess of \$6,000, and advance to a rate of 48% upon incomes in excess

of \$98,000 and not in excess of \$100,000. This advance is uniform with an additional 1% of tax for each additional \$2,000 of income until the income of \$100,000 is reached. From that point the rate of increase is reduced so as to reach the maximum rate of 65% after passing \$1,000,000."

With these rates in effect there will be portions of income over \$1,000,000 upon which the total tax is at the rate of 77%.

So far as individuals are distinctively concerned, an important change effected by the new law is the provision which permits the *deduction* from income of *all the losses* sustained during the taxable year, if incurred in any transaction entered into for profit although not connected with any trade or business. Under previous laws such losses could be deducted only from gains from similar transactions. Individuals are also for the first time permitted to file returns upon the basis of a *fiscal year* other than the calendar year. *Stock dividends* are still expressly taxed, being defined to be income to the amount of the earnings set aside by the corporation in payment for the stock distributed (such amount usually being the par value of the stock), subject, however, to the provision that such dividends are to be taxed at the rates of the year in which the corporation accumulated the earnings from which they are paid. If the Supreme Court, approving the recent decision of the District Court of the Southern District of New York, should hold, as seems likely, that stock dividends are not income within the meaning of the Sixteenth Amendment to the Constitution, all taxes collected by virtue of this provision would of course have to be refunded. The right to deduct certain charitable contributions and gifts to the extent of not exceeding 15% of the income otherwise taxable is retained. Except with a few instances in which there is express provision to the contrary, and except as permitted under the accrual system of accounting, all income received in any taxable year is to be taxed at the rates for that year.

PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS

Individuals carrying on business in partnership are still liable for income tax only in their individual capacity, each partner being taxable on the amount of his distributive share in the partnership earnings for the taxable year whether distributed or not.

There is a new provision for the taxation of income from a "personal service corporation," defining it as a corporation "whose income is to be ascribed primarily to the activities of principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor."

Under this provision the income of such a corporation is taxed as if the corporation were a partnership, and the corporation is not subject to the taxes otherwise applicable to corporations. The income of a corporation formed or availed of for the purpose of preventing the imposition of a surtax upon its stockholders or members by permitting its gains or profits to accumulate instead of being divided shall be taxed to the individual stockholders, as in the case of a personal service corporation. There is no longer any requirement that the corporation be so formed or availed of "fraudulently."

CORPORATION INCOME TAX

Rates: The rate of the flat tax upon corporations is 12% for 1918. In the bill as it passed the Senate the rate for 1919 (payable in 1920) was 8%, but it has been announced that the rate agreed upon in conference for income of 1919 and thereafter is 10%, corporations thus for the first time being subjected to a higher normal income tax rate than individuals. The additional differential rate of 6% upon undistributed income of corporations was struck out in the Senate bill and there is in this bill no provision corresponding to the special tax on undistributed income which appears in the Act of 1917.

Corporations are for the first time given a right to deduct all dividends from other corporations in determining income subject to the flat tax. They are also given the right to *deduct all interest* paid, except upon indebtedness incurred to purchase or carry tax-free obligations other than obligations of the United States issued after September 24, 1917.

DETERMINATION OF BUSINESS INCOME

In some important respects the determination of income from a business, in whatever form conducted, is more

fairly provided for under the new bill than under the present law.

Net Losses: Thus under the present law, the tax for each year stands entirely by itself and the fact that the business suffers a loss in one year has no bearing upon its tax for any subsequent or previous year. The new bill incorporates an amendment which provides that under certain limitations net losses sustained in 1917 or 1918 may be deducted in computing the net income for the succeeding taxable year; that a net loss sustained in the future may be deducted from the net income of the preceding taxable year and if it is in excess of the net income for such preceding taxable year that such excess may be allowed as a deduction in computing the net income for the succeeding taxable year.

Inventories: The new Act for the first time expressly recognizes in terms the necessity for the use of inventories in order to determine business income, and provides that inventories "shall be taken upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income." This provision would, of course, sustain the existing Treasury rule which permits inventories to be taken on the basis of "cost, or cost or market, whichever is lower," and will permit further rules to give effect to the most approved methods for determining income.

Shrinkage: The only express provision in the bill dealing with the vital matter of adjustment of 1918 income on account of shrinkage in inventory values to the present entirely unsettled trade conditions is one to the effect that if it is shown that during the taxable year 1919 or 1920 a taxpayer "has sustained a substantial loss (whether actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory in the preceding taxable year, then the amount of such loss shall be deducted from the net income for such preceding taxable year," and the tax for the previous year shall be redetermined accordingly.

Under these provisions, coupled with the existing Treasury ruling, a taxpayer is permitted to take his December 31st inventory upon the basis of "cost or market, whichever is lower," and is further permitted, if

he discovers during 1919 that there has been a further shrinkage in inventory, to secure a corresponding reduction in his tax for 1918. There is no provision, however, which permits a taxpayer to make a reserve against expected shrinkage in inventory values.

Amortization: The highly important provision is that to the effect that in the case of building, machinery, or equipment installed or acquired on or after April 6, 1917, for production of articles contributing to the prosecution of the present war there shall be allowed a reasonable deduction for amortization. This is designed to take care of the situation of businesses having extensive equipment of little or much less value after the termination of the war. The Senate struck out from this provision a limitation to an amount not exceeding 25% of the net income which had been imposed by the House. At any time within three years after termination of the war, the Commissioner may either at the request of the taxpayer or of his own motion re-examine the taxpayer's return and adjust the amortization allowance from the facts as they have actually developed.

Depletion: In the case of mines, oil and gas wells, other natural deposits and timber there is allowed "a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions of each case based upon cost, including cost of developments not otherwise deducted, provided that in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or of the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date." This is an improvement upon the present provision. It takes care of improvements and for the first time recognizes the interest of the lessee.

Consolidated Returns: The bill in direct opposition to the measure as it passed the House makes provision for a consolidated return of income in the case of affiliated or subsidiary corporations. Income is to be computed on the basis of such return, both for income and for war excess profits tax. The provision is extended to include foreign subsidiaries.

Credit for Foreign Taxes: The bill for the first time gives to a taxpayer who is subject to tax upon any income, war income, or profits tax in any foreign country, a right to credit the amount of such tax against the amount of

tax otherwise payable here, as under the present law there is no deduction or credit for United States income taxes paid, although all other taxes may be deducted except assessments for betterments. In computing income subject to the flat tax, a corporation is permitted to take as a credit as under the present law the war excess profits tax to be assessed for the same period.

PAYMENT OF TAXES

The new Act for the first time makes provision for payment of income and profits taxes in *installments*. There are to be four quarterly installments, beginning March 15th. The Commissioner may extend the time for filing a return and for paying the tax, in which case there is to be added interest at the rate of one-half of one per centum per month for the period of the extension. The normal date for filing returns is March 15th.

A new provision is that limiting the right of the Commissioner to bring any proceeding for the collection of tax more than five years after the tax was due. During the five-year period any adjustment with the taxpayer is to be made on the basis of net amounts found due on examination of all years for which tax is still enforceable.

WAR EXCESS PROFITS TAX

The war excess profits tax, unlike the excess profits tax of 1917, is made applicable to corporations only. The reason for this was stated in the report as follows:

“Individuals and partnerships pay the heavy surtaxes upon all net income, whether left in the business or not, while corporations and their stockholders are relieved from surtaxes upon the portion of the earnings which is not distributed.”

The majority of the committee was, however, forced to the conclusion that

“This inequality is more than compensated for by the fact that the corporation is — while the individual and partnership are not — subject to the war excess profits tax.”

There is no doubt, however, that a partnership having a high income distributed among a few partners pays in effect a higher tax than a corporation, even though not subject to the war excess profits tax.

Rates: The tax for the year 1918 is made up of the sum of the following:

First Bracket

30 per centum of the amount of the net income in excess of the excess profits credit and not in excess of 20 per centum of the invested capital;

Second Bracket

60 per centum of the amount of the net income in excess of 20 per centum of the invested capital;

Third Bracket

The sum, if any, by which 80 per centum of the amount of the net income in excess of the war profits credit exceeds the amount of the tax computed under the first and second brackets.

For the year 1919, the 80% rate is abolished, except as to War Contracts, and the rate in the first bracket changed to 20% while that in the second bracket is changed to 40%.

In effect this Act increases somewhat the excess profits tax of last year and provides for a new 80% tax upon the excess of income over pre-war income or over the statutory deduction.

War Profits Credit: The war profits credit normally consists of a specific exemption of \$3,000 and an amount equal to the average net income of the corporation for the pre-war period (1911-13) plus or minus 10% on the difference between the average invested capital for the pre-war period and the invested capital for the taxable year. If, however, a corporation had no net income for the pre-war period or had income of less than 10%, it is entitled to a 10% deduction. If it was not in existence during at least one calendar year of the pre-war period, it is entitled to the same percentage of deduction as "corporations engaged in a trade or business in the same general class as that conducted by the taxpayer."

Excess Profits Credit: This consists of \$3,000 and an amount equal to 8% of the invested capital for the taxable year.

Invested Capital: Invested capital is determined under the new Act in substantially the same way as under the 1917 law. There has been no change to "capital employed" as urged by the Board, nor is borrowed capital

included except through a relief provision operating only in cases of peculiar hardship. Fundamentally invested capital as defined consists of the sum of the following:

(1) Cash bona fide paid in for stock or shares; (2) The cash value of tangible property bona fide paid in for stock or shares at the time of such payment not to exceed the par value of the original stock specifically issued therefor, unless the actual cash value of such property at the time paid in is shown to have been clearly and substantially in excess of such par value; (3) Paid in or earned surplus and undivided profits, not including surplus and undivided profits earned during the taxable year; (4) Intangible property paid in for stock or shares in an amount not exceeding the lowest of (a) the actual cash value of such property at the time paid in; (b) the par value of stock or shares issued therefor; or (c) 30% of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, in the case of intangible property paid in before that date and otherwise of the stock outstanding at the beginning of the taxable year.

Intangible property is defined as including patents, copyrights, secret processes and formulæ, good-will, trade-marks, trade brands, franchises, and other like property, while all other property is defined as tangible.

By this definition, all tangible property is to include patents, while in last year's law patents were not so treated. As an offset to the inclusion of this additional item to the property subject to arbitrary limitation, the Senate raised this limitation from 20% of the amount of the stock to 30% of such amount.

"Inadmissible Assets." There is to be deducted from invested capital as above defined a percentage equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year, with a certain exception applicable only to dealers in securities, banks or insurance companies. "The term inadmissible assets means stocks, bonds, and other obligations (other than obligations of the United States) the dividend or interest on which is not included in compiling net income," except where there is included in income gains derived from the sale of such assets. It should be noted that in computing the total assets upon the basis of which is determined the percentage deduction for inadmissibles, all assets of the corporation are to be taken even though acquired with borrowed

money. Under last year's ruling by the Department no deduction was required for inadmissibles unless they exceeded the amount of the borrowed money.

Relief Provisions: The present provisions with reference to the definition of invested capital are a little more favorable than those of the Act of 1917 as interpreted by the Treasury Department. Under that Act it was found that the effort to apply any set formula to the determination of invested capital resulted in grave discrimination in the amount of taxes payable in respect of different businesses apparently conducted under substantially similar conditions. To provide relief in cases of such discrimination, the bill contains a somewhat elaborate specification of cases in which discrimination is recognized. Among these are cases in which as compared with a representative corporation the taxpayer would be placed in a position of substantial inequality because of the time and manner of organization or inability to value assets as of March, 1913, and cases in which invested capital is materially disproportionate to the net income as compared with representative corporations: (1) because the capital is in a large part borrowed; (2) because there are excluded from invested capital intangible assets of recognized and substantial value built up or developed by the taxpayer; (3) because the net income for the taxable year is abnormally high due to the realization in one year of gains or profits from income accrued during a period of years; and (4) because proper recognition cannot be made for amortization, obsolescence, or exceptional depletion due to the present war.

The Representative Concern: In cases for relief, the tax of the corporation otherwise discriminated against is to be "an amount which bears the same ratio to its net income as the average tax of representative corporations engaged in a like or similar trade or business bears to their average net income." "In such cases the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under Section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of all profits or excess profits, and all other relevant facts and circumstances."

Reorganization: In the case of a reorganization, consolidation, or change of ownership after January 1, 1911, in a trade or business now carried on, the taxpayer is to be deemed to have been engaged in the trade or business prior to the date of the change. In the case of a reorganization, consolidation, or change of ownership after March 3, 1917, if 50% of the interest or control remains in the hands of the same persons or any of them, no asset transferred or received from the previous owners shall be valued at a greater value than would be allowed to the previous owners.

Provision is made for a refund of the amount of any excess profits tax paid for 1918 by a partnership having a fiscal year ending in 1918.

INHERITANCE TAX

The Senate bill provides for a progressive inheritance tax based upon the size of the share of the individual, heir, or legatee. This is a departure from the present Federal estate tax which is based upon the size of the estate as a whole.

The rates progress from 1% upon the amount by which the beneficial interest passes to any one person exceeds \$10,000 and does not exceed \$25,000, up to 25% of the amount by which any one beneficial interest exceeds \$2,500,000. This tax will when it becomes established yield less revenue than that provided for in the House bill, but was deemed to be upon a far more just basis.

TAX ON TRANSPORTATION AND OTHER FACILITIES

The tax of 3% upon the amount paid for transportation by freight or by water, and of 8% upon the amount paid for transportation of persons by rail, is retained without substantial change. It is provided, however, contrary to the present Treasury ruling, that the freight tax applies "to amounts paid for transportation within the United States for property transported from a point without the United States to a point within the United States." Under the present ruling, through shipments from Canada, for example, are held to be exempt from tax.

TAX ON BEVERAGES

The rate of tax on non-beverage alcohol is retained at the present figure of \$2.20 on each proof gallon. The rate of tax on distilled spirits is advanced to \$6.40 per gallon, being double the present rate, but owing to the prohibitory legislation the beverage tax will raise less than \$500,000,000 for the fiscal year 1918-19, and but \$93,000,000 for the year 1919-20. Under the original rates in the House bill, without allowance for the effect of prohibition, the beverage tax was estimated to yield for the first twelve months \$1,137,600,000.

TAX ON CIGARS AND TOBACCO

The rates of tax on cigars and tobacco are advanced so as to give an estimated yield of about \$240,000,000 instead of the \$200,000,000 which would be raised under the present law.

EXCISE TAXES

The bill retains the present subject of taxation and adds new subjects and increases the rates. The new schedule of flat taxes upon the manufacturer, producer, or importer in respect of a sale of enumerated articles is substantially as follows:

Automobiles, motor cycles	5%
Tires, inner tubes, or accessories	5%
Pianos, organs, piano players, graphophones, records, etc.	5%
All sporting goods	10%
Chewing gum	3%
Cameras	10%
Photographic films and plates, and other than moving picture films	5%
Candy	5%
Firearms and cartridges (except those sold for the use of the U.S.)	10%
Portable electric fans	5%
Thermos and thermostatic bottles	5%
Cigar or cigarette holders	10%
Automatic slot device, weighing or vending machine	5%
Liveries and livery boots, hunting and shooting garments	10%
Articles made out of fur	10%
Toilet soaps and soap powders	3%

The foregoing taxes are to be returned and paid monthly by the manufacturer.

Express provision is made that the excise taxes shall not apply in respect of articles sold for export and in due course exported.

The bill also provides a tax of 10% upon the amount paid on sales for consumption or use for any certain articles in excess of a specific price, such articles including, for example,

- Carpets and rugs, except imported and American rugs, made principally of wool, on an amount in excess of \$5 per square yard;
- Trunks, on an amount in excess of \$50 each;
- Traveling bags, on an amount in excess of \$25 each; .
- Women's hats, on an amount in excess of \$15 each;
- Men's and boys' caps, on an amount in excess of \$2 each;
- Men's and boys' silk stockings or hose, on an amount in excess of \$1 per pair, etc.

Miscellaneous Taxes: Other taxes imposed are 5% upon the retail sales of jewelry; 5% upon the rentals received for *positive motion picture films* containing pictures; one cent on each twenty-five cents on the retail sales of perfumes, essences, extracts, toilet waters, and pills, powders, liniments, salves, and other medicinal preparations and compounds falling under the general class of proprietaries.

Floor Taxes: The bill as it passed the Senate contained no provisions for floor taxes except upon tobacco and upon beverages.

SPECIAL TAXES

Capital Stock Tax: A capital stock tax at the rate of one dollar per thousand dollars of the excess over five thousand dollars "of the amount of its net assets shown by its books as of the close of the preceding annual period used by the corporation for the purpose of making its income tax return" is imposed on each corporation. The simple basis here adopted, if retained, will render unnecessary the present elaborate regulations of the Department for determining "fair value" of capital stock, this being the basis on which the present tax of fifty cents per thousand is assessed.

Stamp Taxes: The stamp taxes as provided for in existing law are retained without essential change.

CHILD LABOR

A special additional tax of 10% of the entire net profit of the previous taxable year is provided for in the case of "every person . . . operating (a) any mine or quarry in which children under the age of sixteen years have been employed or permitted to work during any portion of the taxable year; or (b) any mill, cannery, workshop, or manufacturing establishment in which children under the age of fourteen years have been employed or permitted to work, or children between the ages of fourteen and sixteen have been employed or permitted to work more than eight hours in any day or more than six days in any week, or after the hour of seven o'clock p.m., or before the hour of six o'clock a.m."

This provision applies alike to individuals, partnerships, or corporations. The first taxable year for the purpose of this provision is to be the period between sixty days after the passage of this Act and December 31, 1919.

WAR CONTRACTS

A special provision added on the floor of the Senate would require that every individual, partnership, or corporation which, since the 6th day of April, 1917, "has entered into any contract, undertaking, agreement, or transaction with the United States, or with any agency, officer, or commission of the United States, or with any other person, partnership, or corporation having contract relations with the United States, for the performance of any work or for the supplying of any materials or property for the use of or for the account of the United States to file with the Commissioner of Internal Revenue and with the Attorney General, within sixty days after the passage of this Act, a true and correct copy of every such contract, undertaking, agreement, or transaction, together with a true, accurate, and complete statement of all work and labor performed and materials and property supplied and an account of all moneys or other things of value received, expenses incurred, and profits made and realized from such contract, undertaking, agreement, or transaction."

It is felt that compliance with this provision would in most cases be practically impossible, and would, moreover, impose an exceedingly expensive task upon manufacturers generally and especially upon smaller manufacturers, but in any event the task could not be performed within the sixty days allowed. Urgent recommendations have been made to the Conference Committee looking to its elimination or radical modification of this provision.

POSSIBLE CHANGES AND RULINGS

The Treasury Department is understood to be preparing regulations and forms at the present time with the hope of having them out very soon after the Act is passed. Important points to be covered in the income and war excess profits regulations will relate, among other things, to:

- (1) The basis of inventories. It is to be hoped that the rulings will be somewhat more detailed and suited to the requirements of different industries than heretofore.
- (2) The basis of amortization deductions.
- (3) The basis for adjustment of the 1918 taxes owing to shrinkage in inventory values in 1919.

The public announcements of the Conference Committee appear to indicate that many of the most important provisions have up to the present time been passed over for later settlement. These apparently include such matters as net losses; special inventory loss provision; the amortization provision; the consolidated return; the excess profits rates for 1918; and the war contract provision.

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